No. 2512

In the United States

Circuit Court of Appeals

for the Ninth Circuit

THE WASHINGTON TRUST COMPANY,

Petitioner and Appellee,

vs.

EDWARD H. CHAVELLE, as Trustee of the Estate of Washington Steel & Bolt Company, a Corporation, Bankrupt,

Respondent and Appellant.

ANSWER BRIEF OF WASHINGTON TRUST COMPANY TO BRIEF OF TRUSTEE IN BANKRUPTCY ON CROSS APPEALS.

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It is the contention of the Trustee in Bankruptcy, as appears in his brief filed herein:

1. That the issue of bonds to McPhaden and Pike at 90 cents on the dollar was an *ultra vires* act of the corporation in violation of the constitution and statutes of the State of Washington.

2. That the bonds in question are non-negotiable.

3. That the $25,000 of bonds pledged with the Bank of Montreal as collateral to a pre-existing loan of $20,000 was issued without authority from the Board of Trustees and without any considera-

tion and consequently their issuance was an *ultra vires* act of the corporation and the bonds are void.

4. That the petition for revision and supervision should be dismissed.

5. That an appeal does not lie from an order to sell the property clear and free of encumbrances, and hence the appeal from that order should be dismissed.

6. That a memorandum decision and order was entered on February 7, 1913 and March 3, 1913, by the District Court (pp. 25-28), permitting the trustee in bankruptcy to administer upon the equity of the mortgagor, or surrender the mortgaged property for foreclosure, and not having been appealed from, became the law of the case, and the act of the trustee in obtaining an order to sell free of incumbrances was an election to administer on the equity of the mortgagor.

7. That the petition to the District Court to review the order of the referee was not verified by the Washington Trust Company and that the petition for supervision and revision is not so verified and hence both should be dismissed.

Thus it will be seen that all the defenses raised by the trustee in bankruptcy are technical. There is no question of fraud involved in the case. There is no question that the money advanced as a loan by the bank was not received by the Washington Trust Co. and used by it in its corporate business, nor is there any question but that McPhaden and Pike actually paid into the company the sum of

$33,390, for which they received $37,100 of bonds in settlement. These facts are admitted by the trustee in bankruptcy in his brief. Nor is there any contention in his brief by the trustee in bankruptcy that the bonds issued to McPhaden and Pike were issued for a past consideration and that the issue on that account was *ultra vires*. We shall take up the contentions of the trustee in bankruptcy and answer them separately.

ANSWER TO PARAGRAPH I.

Is the issue of bonds to McPhaden and Pike at 90 per cent of the par value in violation of the constitution and statutes of the State of Washington?

The trustee in bankruptcy cites Article VII, Section 6 of the Washington Constitution and Sec. 3697 of Rem. & Bal.'s Code, upon which he relies to sustain his contentions. Art. XII, Sec. 6 of the Washington Constitution corresponds to the following articles and sections of the constitutions of other states of the union:

Ala. XIV, 6; Ark. XII, 8; Cal. XII, 11; Colo. XIV, 9; Ill. XI, 13; Ky. 193; Pa. XVI, 7.

It must be borne in mind that the trustee in bankruptcy contends that the fictitious indebtedness or increase incurred by the Washington Steel & Bolt Company consists in issuing the bonds at a reduction of 10 per cent of their par value.

It is a well settled principle of corporate law that in the absence of restraining constitutional

provisions or statutes, private corporations have the same power to sell their bonds at less than their par value, which natural persons would have. This flows from the principle that in the absence of statutory provisions, corporations may resort to the same means for the purpose of raising the money to prosecute the objects of their creation, which would be permissable in the case of natural persons.

> *Thompson Corporations* (First Ed.) Sec. 6058-6059.
>
> *Toledo etc. v. Continental Trust Co.*, 95 Fed. 497, 36 C. C. A. 155.

The great weight of authority is to the effect that a constitutional prohibition against the issuing of stock or bonds, except for money or property actually received or labor done, and against the fictitious increase of stock or indebtedness, was intended to protect stockholders against spoilation and to guard the public from securities that were absolutely worthless, and does not indicate a purpose to make the validity of every issue of stock or bonds by a private corporation depend upon the enquiry whether the money, property, or labor actually received was of equal value in the market with the par value of stock or bonds so issued.

> *Memphis & L. R. R. Co. v. Dow*, 120 U. S. 287; 7 Sup. Ct. Rep. 482.
>
> *Clark v. Bever*, 139 U. S. 96, 11 Sup. Ct. Rep. 468, 35 L. Ed. 88.
>
> *Handley v. Stutz*, 139 U. S. 417, 11 Sup. Ct. Rep. 530, 35 L. Ed. 227.
>
> *Brown v. Duluth*, 53 Fed. 889.

Toledo etc. v. Continental Trust Co., 95 Fed. 497, 36 C. C. A. 155.

Firth Co. v. S. C. Loan & Trust Co., 122 Fed. 569, 59 C. C. A. 73.

Lake St. L. R. Co. v. Ziegler, 99 Fed. 144, 39 C. C. A. 431.

Sioux City O. & W. R. Co. v. Manhattan Trust Co., 92 Fed. 428, 433, 34 C. C. A. 431.

Toledo St. L & K. B. C. Co. v. Continental Trust Co., 95 Fed. 497, 517, 36 C. C. A. 155.

Grant et al. v. East & West R. Co. of Alabama, 54 Fed. 569, 4 C. C. A. 511.

Kemmerer v. St. Louis Blast Furnace Co., 212 Fed 63 (8th Cir).

Stein v. Howard, 65 Cal. 616, 4 Pac. 662.

Underhill v. Santa Barbara Land Co., 93 Cal. 30, 28 Pac. 1049.

Nelson v. Hubbard, 96 Ala. 238; 11 So. 428, 17 L. R. A. 375.

Jones "Coroporate Bonds" (3d Ed.) Sec. 186.

In the case of *Stein v. Howard*, 65 Cal. 616, 4 Pac. 662, *supra*, it was held that an increase of capital stock, under a resolution authorizing the additional shares to be sold at 87½ cents on the dollar was not such a fictitious increase of the stock as was prohibited by a constitutional provision similar to that contained in the Washington constitution.

In the case of *Brown v. Duluth*, 53 Fed. 889, *supra*, complainants sought to obtain an injunction restraining a railroad corporation from issuing and selling bonds at 80 per cent of their par value. Under the terms of the sale the company was to receive $1,600,000 cash for $2,000,000 face value of

bonds and $666,666.66 face value of common stock. We take the following from the decision:

"This statute (referring to the Minnesota statute) was enacted to prevent 'watered stock' so called, from being issued or imposed upon the market.

"The question presented in the argument on this branch of the case are: (1) Is such a contract forbidden by the statute *supra?* (2) Can the complainant bring a stockholders suit to prevent the corporation from carrying out the contract? This statute was not intended to prevent or interfere with the usual method of raising money to build railroads, or for any legitimate corporate purpose. It is not to be construed as obstructive to the extent of restricting and hampering corporations in their internal management, and embarrass them in procuring means to carry out the legitimate purpose of the corporation; and unless it appears that, under the guise of building its road, bonds and stock of the defendant company are to be issued and put upon the market fraudulently that do not and are not intended to represent money and property, this corporation is not prohibited from entering into a real transaction based upon a present consideration, and having reference to legitimate corporate purposes. *Beach Corp.*, p. 909, and authorities there cited. Such a transaction is not a scheme or device to evade the statutes."

In the case of *Nelson v. Hubbard* (Ala.), 17 L. R. A. 375, *supra*, the court said:

"The constitutional provision, standing by itself, does not require that the amount of money, or the value of the labor or property for which stock or bonds are issued, shall correspond with the face value of the stock or bonds for which it is issued. It is the statute, (there being a statute in Alabama on the subject of stocks), reinforcing the constitutional provision, which requires such correspond-

ence in value in the case of subscriptions for stock. In the absence of such statutory provisions, the section of the constitution above quoted would be complied with, in the case of stock, which was not a fictitious increase, but was issued for money, labor done, or money or property actually received. In the case of bonds, there is not, as there is in the case of stock subscribed any statutory provision requiring the value of the consideration received by the corporation to correspond with the amount or nominal or face value of the bonds issued therefor. Such bonds are not issued in contravention of the provision contained in the first sentence of the above mentioned section of the constitution, if the issue does not effect a 'fictitious increase of indebtedness,' and if they can properly be regarded as issued 'for money, labor done, or money or property actually received.' *The constitutional provision in question operates to invalidate evidences of indebtedness when there is in fact no debt;* to require every issue of stocks or bonds of private corporations to represent *substantial values* received by the corporations; to impose upon those charged with the disposition of corporate securities the duty to procure therefor *a fair and reasonable equivalent in money*, labor, or property actually contributed to the corporation. Courts of the highest authority, which have considered the effects of such provisions have not construed them, when not fortified by more stringent statutory requirements, as invalidating issues of stocks and bonds in exchange for money, property, or labor, upon such terms as the corporate authorities, in the fair exercise of their judgment and discretion, may deem proper, though the amount received therefor was less than the face value of the securities. (Italics are ours.)

In the case of *Underhill v. Santa Barbara Land etc. Co.*, 93 Cal. 30, 28 Pac. 1049, it was held that an indebtedness of a corporation was not fictitious

within the meaning of Art. 12, Sec. 11 of the California constitution, which is similar to Art. 12, Sec. 6 of the Washington constitution, where the indebtedness consists of notes and mortgages issued by the corporation in consideration of money advanced to it, though but a part consideration for each note had been received at the time of the execution of the not provided the full consideration was later received and there was no fraud.

Also in the case of *McKee v. Title Ins. & Trust Co.*, 159 Cal. 206, 113 Pac. 140, (involving provisions of the California constitution similar to those of the State of Washington), the court said (Italics are ours):

"The company has the lawful right, the same as any natural person, to sell its bonds for any price it can get, provided it acts in good faith, and mere inadequacy of price does not avoid them.

"There is *no rule of public policy* or law of this state *which forbids a corporation from discounting its notes or bonds. It is a common custom, and it has never been held unlawful.* The code provides that no corporation shall issue stock or bonds, 'except for money, paid, labor done or property actually received,' and that any 'fictitious increase' of stock or indebtedness is void. Civ. Code., Sec. 359. The same provision is in the constitution, Article 12, Sec. 11. This does not forbid the sale of bonds at a discount."

In the case of *Memphis v. Dow*, 120 U. S. 287, 7 Sup. Ct. Rep. 482, which appears to be the leading case on the subject, the court, used the following language in interpreting similar provisions of the Arkansas constitution:

"But appellant disputes its liability upon the bonds given for the balance upon the theory that they were prohibited from issuing them by the eighth section of the twelfth article of the constitution of Arkansas, adopted in 1874. That section provides that 'no private corporation shall issue stocks or bonds, except for money or property actually received, or labor done, and all fictitious increase of stock or indebtedness shall be void.' In support of this view, our attention is called to the fact, admitted by the demurrer, that the full value of the property, rights and privileges conveyed to appellant did not exceed $1,300,000, the amount at which the capital stock was fixed; and, consequently, it is argued, the $2,600,000 of bonds were issued without any consideration received in money, property, or labor, and represented only a fictitious indebtedness. In other words, appellant's vendors were fully compensated for their interests by taking to themselves its entire stock.

"We do not concur in this view of the case. It does not, we think, rest upon a sound interpretation of the state constitution. The prohibition against the issuing of stock or bonds, except for money or property actually received or labor done, is against spoilation, and to guard the public against securities that were absolutely worthless. One of the mischiefs sought to be remedied is the flooding of the market with stock and bonds that do not represent anything whatever of substantial value.

"Recurring to the language employed in the Arkansas constitution, we are of opinion that *it does not necessarily indicate a purpose to make the validity of every issue of stock or bonds by a private corporation depend upon the inquiry whether the money, property, or labor actually received therefor was of equal value in the market with the stock or bonds so issued.* There was, consequently, no fictitious increase by appellant of its stock or indebtedness. Under these circumstances, *it cannot*

be fairly said that the bonds secured by the mortgage were issued without any consideration whatever actually received in property." (Italics are ours.)

We desire particularly to call the attention of the court to the case of *Handley v. Stutz*, 139 U. S. 417, 11 Sup. Ct. Rep. 530, wherein an active corporation, for the purpose of paying its debts, and obtaining money to prosecute its business, issued bonds; but finding it impossible to negotiate them, it issued shares of capital stock in an amount equalling the par value of the bonds as an additional inducement to the purchase. While the facts in that case were not similar to the ones involved here, the principles of law discussed and laid down by the court are applicable to the case at bar. The court held that the transaction, although practically amounting to a bonus or gift of stock as an inducement to buy bonds, was a regular one and fell within the corporate powers of an active corporation pressed for funds for properly carrying on and continuing its corporate business. The transaction in that case netted the corporation less than the par value of the bonds negotiated. We take the following extracts from the decision of the court. (Italics are ours.):

"The case, then resolves itself into the question whether an active corporation, or, as it is called in same cases, a 'going concern,' finding its original capital impaired by loss or misfortune, may not, for the purpose of recuperating itself and providing new conditions for the successful prosecution of its business, issue new stock, put it upon the

market, and sell it for the best price that can be obtained. The question has never been directly raised before in this court, and we are not, consequently, embarrassed by any previous decisions on the point.

"To say that a corporation may not, under the circumstances above indicated, put its stock upon the market, and sell it to the highest bidder, is practically to declare that a corporation can never increase its capital by a sale of shares, if the original stock has fallen below par. The wholesome doctrine, so many times enforced by this court, that the capital stock of an insolvent corporation is a trust fund for the payment of its debts, rests upon the idea that the creditors have a right to rely upon the fact that the subscribers to such stock have put into the treasury of the corporation, in some form, the amount represented by it; but *it does not follow that every creditor has a right to trace each share of stock issued by such corporation, and inquire whether its holder, or the person of whom he purchased, has paid its par value for it.* It frequently happens that corporations, as well as individuals, find it necessary to increase their capital in order to raise money to prosecute their business successfully, and one of the most frequent methods resorted to is that of issuing new shares of stock and putting them upon the market for the best price that can be obtained; and, so long as the transaction is bona fide, and not a mere cover for 'watering' the stock, and the consideration obtained represents the actual value of such stock, the courts have shown no disposition to disturb it.

* * * * * * * *

"A case nearer in point is that of *Clark v. Bever, ante,* 468 (139 U. S. 96), (decided at the present term of this court). In this case, a railroad company, of which defendant's intestate was president and stockholder, had a settlement with a construction company, of which defendant's in-

testate was also a member, for work done in building the road. The railroad company, being unable to pay the claim of the construction company, delivered to it 3,500 shares of its stock at 20 cents on the dollar, and the same were accepted in full satisfaction of the debt.

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"*But we think that an active corporation may, for the purpose of paying its debts, and obtaining money for the successful prosecution of its business, issue its stock, and dispose of it for the best price that can be obtained. Stein v. Howard*, 65 Cal. 616, 4 Pac. Rep. 662. As the company in this case found it impossible to negotiate its bonds at par without the stock, and as the stock was issued for the purpose of enhancing the value of the bonds, and was taken by the subscribers to the bonds at a price fairly representing the value of both stock and bonds, we think the transaction should be sustained, and that the defendants cannot be called upon to respond for the par value of such stock, as if they had subscribed to the original stock of the company." (Italics are ours).

The above case and the case of *Fogg v. Blair*, U. S., 11 Sup. Ct. Rep. 476, lay down the rule that what is an equivalent received by the corporation for an issue of its bonds or stocks defends primarily upon the actual market value of the bonds or stock at the time they are issued or negotiated. The presumption is, where there is no evidence to the contrary, that the transaction was regular, and that which was actually received was all that the bonds were worth at that particular time. In the case of a recently created corporation, as in the present case, with no other faith and credit behind it except its personal and real property, it could not be

expected that its bonds would sell for their par value. As the court points out in the *Firth Co. v. South Carolina*, 122 Fed. 569, 59 C. C. A. 73: "Naturally and necessarily the bonds of a manufacturing corporation, just entering business, whose success and credit are not yet established, cannot command a ready sale and cannot be sold except at a large discount. Hypothecation prevents the sacrifice of the bonds, and gives every opportunity to try the future. If this be successful, the bonds can be realized in money without loss. If unsuccessful, the loss will be not greater than such as would occur if the bonds were forced on the market." There is no evidence in the present case that the bonds were issued to McPhaden and Pike at less than the actual market value of the bonds, and it will be presumed that that which was actually paid for them represented their market value at that time.

We could go on and quote numerous other authorities to the same effect but we shall not uselessly consume the time of the court.

But even in the case of the issue of bonds by public and municipal corporations where the statutes expressly direct that such bonds shall not be disposed of at less than par, the weight of authority is to the effect that a general authority to dispose of bonds at not less than par carries with it the implied authority to employ reasonable and proper assistance and pay commissions, and other expenses of getting the bonds on the market, when in the judgment of the officers it is necessary to do so.

39 *L. R. A.* (N. S.), 248 and cases cited.

Church v. Hadley (Mo.), 145 S. W. 8, 240 Mo. 680.

We invite the court's attention to the case of *Church v. Hadley*, 145 S. W. 8, *supra*, which is an exhaustive treatise on the subject citing many authorities.

In *Armstrong v. Ft. Edward*, 159 N. Y. 315, 53 N. E. 1116, the court said, "Where there is an express grant of power to them it carries with it by necessary implication every other power needful and proper to the execution of the power expressly granted."

In the case of *N. Y. v. Sands*, 105 N. Y. 210, 11 N. E. 820, it was said that it was not necessary that the person to whom the commission was paid be a broker.

In *State v. West Duluth Land Co.*, 75 Minn. 456, 78 N. W. 115, it was held that where a commission of 10 per cent of the face value of the bonds was allowed out of the proceeds of the bonds the latter were not void.

In *Manitou v. First Nat. Bank*, 37 Colo. 344, 86 Pac. 75, it was held that a contract made with a broker providing for paying him a commission out of the proceeds of the sale was not *ultra vires*.

In the present case the resolution of the Board of Trustees of September 1, 1908, authorizing the execution of the trust deed, also authorized a settlement with McPhaden and Pike at 90 per cent of the par value of the bonds. This resolution is a part

and parcel of the trust deed. In fact, it is the authority for the execution of the mortgage, and as between McPhaden and Pike and the corporation they should be read together. By the resolution itself the issue of bonds to McPhaden and Pike did not fall within the prohibition of the last paragraph of the mortgage that no bonds should be disposed of at less than 5 per cent discount. Certainly if the intention of the parties had been otherwise, McPhaden, who executed the mortgage as president, and Pike, as secretary, would have seen to it that the provision read otherwise. Further, McPhaden received no salary as president of the corporation, and none of his expenses for disposing of these bonds were paid out of the corporate funds, (p. 183). As the trustee in bankruptcy points out in his brief, McPhaden owned nearly all of the stock of the corporation. Certainly where such is the case, and in view of the holdings of the Supreme Court of the United States that such provisions as are contained in the Washington constitution and statutes were enacted primarily for the benefit of the stockholders, we submit that all the contracts in the present case having been entered into at the instigation of McPhaden should be upheld.

The trustee in bankruptcy admits in his brief, (p. ——), that the Washington constitution and statutes do not in express terms prohibit a corporation from issuing its stock at less than its face value and all of the Washington authorities cited by him (p. ——) are in no way in point. All of

those cases involved suits by creditors or receivers of an insolvent corporation for unpaid subscriptions to the capital stock of the corporation, on the theory that such subscriptions constituted a trust fund to be reached in equity by the creditors. No such question is here involved. It is sufficient to call attention to the case of *Hollins v. Brierfield Coal & Iron Co.*, 150 U. S. 371, 14 Sup. Ct. Rep. 127, where the court in defining the relations between a corporation and its creditors goes on to say:

" * * * * In other words,—and that is the idea which underlies all these expressions in reference to 'trust' in connection with the property of a corporation—the corporation is an entity distinct from its stockholders as from its creditors. Solvent, it holds its property as any individual holds his, free from the touch of a creditor who has acquired no lien; free also from touch of a stockholder, who, though equitably interested in, has no legal right to the property."

The cases of *Jorguson v. Apex Gold Min. Co.*, 74 Wash. 243, 133 Pac. 465, and *Kom v. Cady Detective Agency*, 76 Wash. 549, 136 Pac. 1155, have no bearing on the issues involved in the present case. The bond in the *Jorguson case* was an ordinary indemnity bond and the court refused to sanction the contract between the parties, which on its face was against public policy and in direct violation of the Washington statute. The *Kom case* was a somewhat similar case.

In those cases a corporation attempted, in effect, to pay dividends before they were earned to certain stockholders, out of all proportion to the net

profits of the corporation, when the statute requires that dividends must be paid proportionately and out of the net profits. The facts in this case present no such question as was presented in those cases. A mere reference to the section and statute and the constitution quoted by the trustee in his brief will disclose that the provisions of the statute regulating stock of a corporation under which the above actions were prosecuted have no application to bonds of a corporation, and that the provisions regulating bonds and those regulating stock of corporations are entirely different.

We are not disputing with the trustee in bankruptcy over the definition of an *ultra vires* contract of a corporation as set forth in the *Central Transportation Co. v. Pullman's Palace Car Co.*, 139 U. S. 24, 11 Sup. Ct. Rep. 478. In that case the corporation attempted to do something absolutely foreign to the purpose for which it was incorporated. In the case at bar the corporation did what it was authorized to do by the statute and articles of incorporation; that is, to issue and sell bonds. If, in no event, a private corporation could issue and sell bonds, and the issuing and selling of bonds was something entirely foreign and different from the objects of its creation, then the *Pullman Palace Car Co. case* might have some application. Further, by an examination of that opinion it will be seen that the *Pullman Palace Car Co.* was a railroad corporation and that it attempted to lease and demise to another corporation all of its railway cars, con-

tracts, patent rights, and personal property. A Pennsylvania statute positively prohibted such a corporation from transferring its property in such a manner. It was created to conduct, to carry on its business, not to sell it out, and the decision in the case of the *Pullman Palace Car Co.* was largely based upon the fact that the corporation was a *quasi* public corporation, and that it owed duties to the public which it could not escape in that manner and concedes that in the case of a private corporation its ruling would have been different. The court, in its opinion, concludes, "The plaintiff, therefore, was not an ordinary manufacturing corporation such as might, like a partnership or an individual, engage in manufacture, sell or lease all of its property to another corporation," and further along in the opinion the court says, "The plaintiff was not a strictly private, but a *quasi* public corporation; and it must be so treated as regards the validity of any attempt on its part to absolve itself from the performance of those duties to the public, the performance of which by the corporation itself was the remuneration that it was required by law to make to the public in return for the grant of its franchise. *Pickard v. Car Co.*, 117 U. S. 34, 6 Sup. Ct. Rep. 635; *Railroad Co. v. Winans*, 17 How. 30, 39; *Railroad Co. v. Lockwood*, 17 Wall. 357; *Liverpool & G. W. Steam Co. v. Phenix Ins. Co.*, 129 U. S. 397, 9 Sup. Ct. Rep. 469."

The court also says in its opinion:

"There is strong ground, also, for holding that

the contract between the parties is void, because in unreasonable restraint of trade, and therefore contrary to public policy."

So it will be seen that the ruling in the *Pullman Palace Car Co. case* has no application to the case at bar. As they appear in the same volume as the *Pullman Palace Car Co. case*, we again invite the attention of the court, in this connection, to the cases of

> *Clark v. Beaver*, 139 U. S. 96, 11 Sup. Ct. Rep. 468, 35 L. Ed. 88.
>
> *Fogg v. Blair*, 139 U. S. 118, 11 Sup. Ct. Rep. 476, 35 L. Ed. 104.

eupree vs. Watson, 216 Fed. 468.
olt vs. Henley, 232 U.S. 637.
ank of North America, vs. Penn. Motor Car Co., 83

same month. In fact, the *Pullman Palace Car Co. case* and the *Beaver case* and the *Blair case* were decided on the same day, and there is no conflict in the opinion between them. They announce separate and distinct principles applicable to separate and distinct state of facts.

But even if this were a proper case for the defense of *ultra vires*, it would not avail the trustee in bankruptcy.

The following cases declare that neither the corporation nor its creditors can, under like circumstances to those here existing and under similar provisions of the law, maintain such an attack on bonds irregularly issued, and that the provisions of such laws are for the protection of stockholders, only. *McKee v. Title Ins. & Trust Co.*, 159 Cal.

tracts, patent rights, and personal property. A Pennsylvania statute positively prohibted such a corporation from transferring its property in such a manner. It was created to conduct, to carry on its business, not to sell it out, and the decision in the case of the *Pullman Palace Car Co.* was largely based upon the fact that the corporation was a *quasi* public corporation, and that it owed duties to the public which it could not escape in that manner and concedes that in the case of a private corpora- [illegible] would have been different. The court, [illegible]

engage in manufacture, sell or lease [illegible] erty to another corporation," and further along in the opinion the court says, "The plaintiff was not a strictly private, but a *quasi* public corporation; and it must be so treated as regards the validity of any attempt on its part to absolve itself from the performance of those duties to the public, the performance of which by the corporation itself was the remuneration that it was required by law to make to the public in return for the grant of its franchise. *Pickard v. Car Co.*, 117 U. S. 34, 6 Sup. Ct. Rep. 635; *Railroad Co. v. Winans*, 17 How. 30, 39; *Railroad Co. v. Lockwood*, 17 Wall. 357; *Liverpool & G. W. Steam Co. v. Phenix Ins. Co.*, 129 U. S. 397, 9 Sup. Ct. Rep. 469."

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All four of these cases were decided during the same month. In fact, the *Pullman Palace Car Co. case* and the *Beaver case* and the *Blair case* were decided on the same day, and there is no conflict in the opinion between them. They announce separate and distinct principles applicable to separate and distinct state of facts.

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The following cases declare that neither the corporation nor its creditors can, under like circumstances to those here existing and under similar provisions of the law, maintain such an attack on bonds irregularly issued, and that the provisions of such laws are for the protection of stockholders, only. *McKee v. Title Ins. & Trust Co.*, 159 Cal.

206, 113 Pac. 140; *Anderson v. Bullock Co. Bank*, 122 Ala. 275, 25 South 523; *Bishop v. Kent*, 20 R. I. 685, 41 Atl. 257; *Rochester Bank v. Averell*, 96 N. Y. 475; *Paulding v. Chrome Steel Co.*, 94 N. Y. 334; *In re N. Y. Economical Pr. Co.*, 110 Fed. 519, 49 C. C. A. 133; *Hervey v. Ill. Midland Ry. Co.* (C. C.), 28 Fed. 174; *Manhattan Hdw. Co. v. Phalen*, 128 Pa. 110, 18 Atl. 428; *Wood v. Corry* (C. C.), 44 Fed. 150, 12 L. R. A. 168; *Nelson v. Hubbard*, 96 Ala. 252, 11 South 428, 17 L. R. A. 375; *Eastmen v. Parkinson*, 133 Wis. 375, 113 N. W. 649, 13 L. R. A. (N. S.) 921.

ANSWER TO PARAGRAPH II.

We have already treated of the negotiability of the bonds in our main brief on the subject and refer the court to our argument there made.

ANSWER TO PARAGRAPH III.

In paragrahp III of his brief, the trustee in bankruptcy claims that the $25,000 of bonds pledged to the bank as collateral was issued without any consideration and without authority from the board of trustees.

The trustee in bankruptcy does not specifically allege in just what the want of consideration consists, but we presume that he claims that the issuance of the bonds as security for the past indebtedness is an issue without consideration. We have already treated this subject in our brief in chief, citing many authorities holding that a past indebtedness is a sufficient consideration for an issue of bonds provided there is no fraud and the trans-

action is bona fide, but we shall add something further here.

In regard to this same subject, the Circuit Court of Appeals in the case of *First Savings & Trust Co. v. Waukesha Canning Co.*, 211 Fed. 927, (7th Cir.) said:

" 'But,' says appellee, quoting the language of Judge Ross at the Circuit, 'the money paid, labor done, or property actually received, must be paid, performed, or received, as the case may be on account of the issuance of the bonds; and any bonds issued contrary to this provision are of course illegally issued. The provision does not mean, and cannot be held to mean, that such bonds may be issued as collateral security for any sort of pre-existing indebtedness.'

"The language of the statute does not, in our view of it, justify the conclusion arrived at in the case just quoted. If it be that an increase of the interest of the corporation in its assets is equivalent to the acquirement of property to the amount of such increase, and it be further true that the agreement of the creditors to accept the bonds at a valuation of 75 per cent of their face upon their several claims results in the reduction of the unsecured indebtedness in a sum equal to 75 per cent of the face of the bonds, why does not the placing of the bonds as collateral result in the enhancing, to that extent, of the interest of the appellee in its property just as advantageously as though appellee had acquired that much more property and incurred the bonded debt, as well as its unsecured indebtedness? How can it then be said that the issue of bonds was not made for money or labor or property at its true money value actually received? The statute is not in its terms technical. It does not attempt to say how the money, labor, or property shall be procured. It is said in *Nelson v. Hubbard*, 96 Ala. 238, 11 South 428, 17 L. R. A. 375.

'And we do not think that such pledge (to secure debts already contracted), if made without fraud, and solely for the bona fide purpose of satisfactorily securing the payment of corporate debts, can properly be regarded as effecting a fictitious increase of indebtedness, or as not issued for money, labor done, or money or property actually received."

"This case is cited approvingly by the United States Circuit Court of Appeals for the Fourth Circuit in *Firth Co. v. S. C. Loan & Trust Co.*, 122 Fed. 575, 59 C. C. A. 73, and in *Illinois Trust & Savings Bank v. Pacific Ry. Co.*, 117 Cal. 332, 49 Pac. 197.

"The United States Circuit Court of Appeals for the Second Circuit held, in *Re Waterloo Organ Co.*, 134 Fed. 345, 346, 67 C. C. A. 327, where a bond issue was transferred to a bank to secure accrued and future indebtedness, that the transaction complied with the requirements of the New York statute which provides that:

'No corporation shall issue either stock or bonds except for money, labor or property actually received for the use and lawful purposes of such corporation."

"The court says in *Hoskins v. Seaside Ice Mfg. & Cold Storage Co.*, 68 N. J. Eq. 476, 59 Atl. 645:

'Nor does the fact that some of these bonds were taken as collateral security for an existing debt make the holder any less a bona fide holder for value than if he was a purchaser for cash."

In the present case it must be borne in mind

We invite the Court's attention to all of the authorities cited in the above case.

The case of *Gould v. Railway Co.*, 52 Fed. 504, 680, cited approvingly in *Sutton Mfg. Co. v. Hutchinson*, 63 Fed. 504, 11 C. C. A. 320, was a case involving the validity, as against the creditors of a railroad corporation, of a deed of trust exe-

cuted as additional security to certain stockholders and directors who had previously advanced large sums to it and for the repayment of which the company had already pledged some of its mortgage bonds. The only difference between the *Gould case* and the present case being that in the present case the first bonds pledged to the Bank of Montreal were the individual property of two of the directors, whereas in the *Gould case* all of the bonds were the property of the corporation itself.

that the Washington Steel & Bolt Company was out nothing in the way of collateral or otherwise on the $20,000 loan until it pledged the $25,000 in bonds on March 20, 1911. The bonds which were originally put up with the bank as security on this were the individual bonds of McPhaden and Pike. On the same reasoning as advanced in the case above quoted from the Washington Steel & Bolt Company received therefor in value for the issue of these $25,000 of bonds 80 cents on the dollar, and further prevented any action or steps by the bank towards enforcing the collection of the loan or foreclosure on the trust deed. It is immaterial that the loan was already partially secured by $22,900 of bonds from McPhaden and Pike. The bank, when the interest was in default, very properly demanded further security.

ANSWER TO PARAGRAPH IV.

While the Washington Trust Company has appealed from the judgment of the District Court, both as to the disallowance of certain bonds and the

confirmation of the order directing a sale of the property, it has also sought a review of the order directing a sale of the property by petition and notice. It did so because of the confusion that seemed to exist among the different courts upon that point. While there is confusion on the point, we are of the opinion that the order directing a sale of the property is reviewable by appeal, in any event, and as well by a petition for review, and that either or both methods might be employed, for the following reasons:

1. That the proceedings involving the validity of the bonds and the petition for the sale of the property filed by the trustee in bankruptcy were, to all intents and purposes, and in legal effect, consolidated and tried as one controversy in the court below. It was stipulated that the same testimony should be used by the referee and also by the District Court in considering both matters. They were submitted together and considered together by the District Court, and passed upon at the same time, and as one matter, and became different branches of one and the same controversy.

2. That the Washington Trust Company was entitled to appeal under Section 24a of the bankruptcy law of July 1, 1898, Sec. 541, 30 Statutes 553 U. S., compiled statutes 1901, page 3431, which vests in the Circuit Court of Appeals appellate jurisdiction over all controversies arising in a bankruptcy proceedings over which those courts would have had jurisdiction if this controversy had arisen

in the Federal Court in other cases outside of proceedings in bankruptcy. The controversy raised by the petition of the trustee to sell free of encumbrances and the answer of the Washington Trust Company thereto and the evidence taken thereon clearly comes within the class of controversies appealable had the controversy arisen in the Federal Courts in a case outside of the proceedings in bankruptcy.

> *Hewitt v. Berlin Machine Works*, 194 U. S. 296, 24 Sup. Ct. Rep. 690, 48 L. Ed. 986.
>
> *Dodge v. Norlin*, 133 Fed. 363, 66 C. C. A. 425.

The court on page 367, in discussing this point, says. (Italics are ours):

"By section 25a it granted to the Courts of Appeals additional jurisdiction which before the enactment of the bankrupt law they could not exercise, and provided a different time within which this jurisdiction might be invoked, to the end that the proceedings in bankruptcy might not be unduly delayed. But there is nothing in the provisions of section 25a which excludes, revokes, or diminishes the general appellate jurisdiction granted by the previous section over controversies within the jurisdiction of the Courts of Appeals before the bankruptcy law was passed. The extent of its effect is to grant some additional jurisdiction, and to restrict to 10 days the time within which the jurisdiction of the Court of Appeals may be invoked in the three classes of cases there specified.

"Nor is there anything in the grant by section 24b of the power to revise and superintend in matter of law the proceedings of the inferior courts of bankruptcy *which in any way affects or limits the general appellate jurisdiction* vested by the sections of the law which have been considered."

3. We believe the appellate courts are coming more and more to regard the classifications made by Sections 25a and 25b as being accumulative and not exclusive.

Thomas v. Woods, 173 Fed. 585, 97 C. C. A. 535.

In this section the court says on page 587. (Italics are ours):

"At the outset we are confronted with the question which has become a part of nearly every bankruptcy cause in an appellate court, namely: Should the review have been sought by appeal or petition? The confusion existing on this subject has been frequently confessed by the courts. In *re McMahon*, 147 Fed. 684, 77 C. C. A. 668; *Coder v. Arts*, 213 U. S. 223, 232, 29 Sup. Ct. 436, 53 L. Ed. 772. The classification of matters in bankruptcy as 'proceedings in bankruptcy' and 'controversies arising in bankruptcy proceedings' is vague and in actual application has bewildered the courts and the legal profession. It is quite manifest that, when the decision of a trial court in a 'bankruptcy proceeding' is brought under view in an appellate court, it presents a 'controversy', and of necessity this is also a 'controversy arising in a bankruptcy proceeding'. The phrases, therefore, upon which this classification is based, are *tautological*."

ANSWER TO PARAGRAPH V.

We are not aware that we are seeking by petition and notice a review of the court's decision touching the validity of the bonds. A review of this point is sought by appeal.

ANSWER TO PARAGRAPH VI.

The first contention in this sub-division of the

trustee's brief is that the petition for review was verified by the attorney of the Washington Trust Company and not by an officer or agent of the Washington Trust Company. The verification itself assigned as a reason for its being made by the attorney that the officers were without the County of King and no officer nearer than Spokane in said state, (See Sec. 281, Rem. & Bal.'s Code), and it can be truly said also that the attorney is the agent of his client for purposes connected with the litigation. Ten days only being allowed to file a petition for review from the referee to the District Court, it would be impossible to get the verification of corporations living at a long distance from the place of trial.

We also contend in this connection that a verification is not necessary. It is admitted in the brief that there is no statute or general order requiring a verification, and the only thing suggesting the propriety of one is the blank forms. The only office of verifications upon pleadings is to give credit to statements of fact and compel truthfulness in the statement of facts. It avails nothing to have a person verify pleadings which raise questions of law, or set forth the contentions of a litigant, and therefore a verification would naturally have no place in connection with a petition for review. We also contend that since the statute is silent, that forms cannot make that invalid which is valid according to the terms of the statute.

West Company v. Lea, 174 U. S. 590, 19 Sup. Ct. 836.
891.

In this connection, we will state that we have no complaint to make concerning the position taken by the trustee to the effect that the order of March 3, 1913, directing that the trustee either administer upon the equity of redemption or surrender the mortgaged property to the mortgagee for foreclosure. We believe, with counsel for the trustee in bankruptcy, that this became the law of the case, but we do contend that the selling of the entire property for cash and cutting off the rights of the mortgagee is not administering upon the equity of redemption for the benefit of general creditors. It is an attempt to administer upon the entire property. We contend that the proper construction of that order in connection with the sale of the property is that the trustee in bankruptcy might sell the equity of redemption; or in other words, sell the property subject to the mortgage for the benefit of general creditors. If the court intended that the trustee in bankruptcy should sell the entire property it would not have required him to "administer upon the equity of redemption" or "surrender the property to the mortgagee for foreclosure." The very purpose of requiring a trustee to administer upon the equity of redemption, or rather upon the property subject to the mortgage or surrender the property to the mortgagee for foreclosure was to enable the bond holders and the

mortgagee to protect themselves in the way most advantageous to themselves. If there is nothing in the property, above the mortgage, for the general creditors, the trustee in bankruptcy could have no interest in it, and ought not to cling to it simply for the purpose of incurring costs and expenses to the mortgagee and preventing it from freely protecting itself and the bond holders in the premises. If there is no equity in the property for general creditors it was the duty of the trustee in bankruptcy to abandon the property for foreclosure purposes, as directed in said order. In the case of *In re Uelner*, 193 Fed. 787, the court upon this point says:

"It is urged by petitioner that his contract stipulates for a sale without appraisement, and if the property is sold by the trustee it will have to bring three-fourths of an appraisement made in the bankruptcy proceedings; that it will be subject to the payment of fees of an auctioneer, of the trustee and referee in bankruptcy, and of appraisers appointed in the proceedings; that the cost of advertising the property will be at a higher rate, and the advertisement will occupy more space, than if sold by the sheriff; and that he would not have the right to bid in the property and offset his debt against the price, but would be compelled to pay the full amount over to the trustee and await a distribution in due course.

"It is well settled that the trustee is not required to administer property burdened with liens or mortgages, and he may abandon same to the secured creditor. In fact, it is his duty to do so whenever it is certain the general estate will derive no benefit from the sale of such property. In such contingency it was the practice under

former bankruptcy acts for mortgage creditors to foreclose in the Federal Courts, and the jurisdiction, regardless of citizenship, with special reference to Louisiana mortgages, was upheld by the Supreme Court in *Ex parte Christy*, 3 How 317, 11 L. Ed. 603, and *Nugent v. Boyd*, 3 How. 437, 11 L. Ed. 664. If the bonds in this case are held to be invalid, of course, the bond holders have no interest in the property, but if they are held valid, and the amount due on them exceeds the price which may be offered for the property, certainly no such sale should be confirmed and no sale should be made, and as argued in our brief in chief, until the validity of the bonds had been determined.

In order of Judge Howard of the lower court, which counsel argues became the law of this case (p. 26 to 29, inc.), expressly states:

"If the equity of redemption is of any value, it should be administered for the benefit of the general creditors at their expense, but if it is of no value, the trustee should not concern himself or incur any expense in connection therewith."

And on page 27 of the record in the same memorandum decision Judge Howard says:

"If he (referring to the trustee in bankruptcy) elects to administer the equity of redemption he must do so at the expense of the general creditors and in such manner as not to unduly hamper or delay the mortgagee in the collection of its debt."

From these quotations it is apparent what the court meant by the administration by the trustee in bankruptcy of the equity of redemption.

ANSWER TO PARAGRAPH VII.

The point is here charged that no evidence accompanied the petition for review, and therefore the court should not consider the testimony. An-

swering this contention, we urge that the appeal and the petition and notice are consolidated in this court, docketed under one number and here as a single cause, and the testimony is here in that cause, duly certified. It is admitted by counsel for the trustee in bankruptcy (Brief p. —), that this testimony was the testimony before the referee and court upon the petition for the sale of the property. It is properly here in support of the petition for review as well as the appeal. It certainly would have been a useless and extravagant expense t ohave had two records containing exactly the same material in a single matter.

Counsel for the trustee in bankruptcy argues that the order of the refere does not provide that the sale should be made for cash. It was so intended and construed by the referee and by the court and the parties in interest, and can have no other construction. The court refused to insert a clause permitting the bond holders to use their bonds in bidding, which will appear from the certificate of the judge at the close of the provisions proposed by the Washington Trust Company; (See Record p. 130). The order of the referee directing that the property be sold is as follows:

"And it is further ordered, adjudged and decreed that the said Edward H. Chavelle, as trustee, be and he is hereby authorized, directed and permitted to sell and dispose of said property in the mortgage more particularly mentioned and described, free of and from the lien thereof and that the proceeds arising from the sale of said property

be held by the said trustee subject to the lien of the said mortgage as if said property had not been sold, subject to the final order, judgment and decree of this court adjudicating the validity *bona fides* and extent of said mortgage."

The effect of this order is that it shall be for cash, otherwise the proceedings arising from the sale could not be held by the trustee awaiting further disposition. The court, in modifying the judgment rendered by the referee concerning the validity of the bonds, also recited in effect that the property was ordered sold for cash, (see Record p. 113). The value placed upon the property of the bankrupt is rather what it should be worth than what it would really sell for in the market and we believe that it is the sincere conviction of the trustee in bankruptcy, as well as the Washington Trust Company, that the property will not sell for enough to pay 25 cents on the dollar upon the par value of the bonds if they are held valid, and if the trustee in bankruptcy insists upon the values assigned to this property, then he should be required, if he sells it over the objection and protest of the mortgagee, to obtain a sufficient sum to pay the bonds in full and if he is unable to do that, within a reasonable time, he ought to be required to surrender the property to the bond holders to be foreclosed upon in their own way and not force them to a procedure which may prove burdensome and expensive. The trustee in bankruptcy has never had charge of this property, with either the consent or acquiescence of the

bond holders, or the Washington Trust Company, but has always held the same over their protest, and against their will and no expense should be charged against the bond holders in favor of the trustee for such holding and such action.

We urge also in support of the validity of the bonds held valid by the court, the principle of estoppel. We have discussed this principle, in its application to this case, in our brief on appeal, and shall not repeat our argument here, and will content ourselves with calling the court's attention to the fact that the general power of a private corporation in this state to execute bonds secured by trust deeds is not questioned and the only thing that is urged is the alleged irregularity of the issue of the bonds and that the argument of counsel for trustee in bankruptcy wuold apply only in cases where the corporation had no corporate power to issue bonds, and that the issuing of bonds such as the ones in question were entirely foreign to the powers conferred upon the corporation by statute or its articles of incorporation. The corporation having atuhority to issue bonds, the principle of estoppel is applicable.

D'Esterre v. City of New York et al, 104 Fed. 605, 44 C. C. A. 75.

Miller v. Perris Irr. Dist. et al, 99 Fed. 143-145.

In Orleans v. Platt, 99 U. S. 676, 25 L. Ed. 404.

In McKee v. Title Ins. & Trust Co., 159 Cal. 206, 113 Pac. 140.

The last case has come to our attention since writing our brief on appeal, and it is so similar in facts to the case at bar that we quote from the opinion as follows:

"The assignee in insolvency represents the interests of the creditors only. He is not suing on behalf of the stockholders or in their interest, and, there being no fraud, he stands in the shoes of the corporation with regard to the bonds. The corporation has received the money obtained by means of the obnds and has applied it to the payment of its debts and completion of the hotel. The money has thus inured to the benefit of the corporation and its stockholders and of the general creditors also, since it has unquestionably given a substantial value to a structure which would otherwise be comparatively worthless. The corporation is therefore estopped to dispute the validity of the bonds and the creditors are likewise bound thereby. The real point of the objection is that the manner of issuing the bonds was so defective that the transaction was *ultra vires* and void, notwithstanding that the corporation received and holds the benefits thereof. In regard to a similar claim the New York Court of Appeals said: 'That kind of plunder which holds onto the property, but pleads *ultra vires* against the obligation to pay for it, has no recognition or support in the laws of this state.' *Seymore v. Association*, 144 N. Y. 333, 39 N. E. 365, 26 L. R. A. 859."

We believe that because of the reasons set forth in this brief, that part of the judgment of the lower court holding certain bonds valid should be affirmed.

Respectfully submitted,

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